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DIRECTORATE OF INTELLIGENCE

15 July 1985

Pakistan: Perspective on Financial Crisis

SUMMARY

Pakistan Foreign Minister Yaqub Khan's request for emergency US financial assistance during his visit to Washington this week is designed to forestall the need to make politically unpalatable cuts in imports or to initiate revenue raising measures at home. He is likely to contend that Pakistan cannot turn to the IMF because the Fund would require economic reforms that the nascent Pakistani democracy is not yet equipped to handle.

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The Setting

Pakistan's economic growth over the past seven years--averaging 6 percent annually in real terms--has been outstanding by developing country standards. Still, its economy remains fragile and often dependent on forces--weather and foreign economic developments--over which it has no control.

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This paper was prepared by Pakistan, Afghanistan, Bangladesh Branch, Office of Near Eastern and South Asian Analysis. Comments and queries are welcome and may be directed to the Chief, South Asia Division, NESAs, on

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State Dept. review completed

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[redacted]

The current economic problems had their origin over a year ago with a disastrous cotton crop and the beginning of a decline in remittances from overseas workers. The government, in its attempts to maintain an appearance of economic prosperity, has avoided import and other spending cuts that would have mitigated at least some of the current troubles. Instead, the government has spent the foreign exchange reserves it had accumulated over several years--when worker remittances were growing--to "buy" economic stability and to modernize its military. [redacted]

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An IMF team arrived in Pakistan in early July to review Islamabad's request for \$330 million in aid to help bolster foreign exchange reserves. [redacted]

[redacted] Islamabad is unlikely to pursue its request with the IMF if adequate funding is available from the US. The IMF, on the other hand, is not likely to provide all the funds requested without domestic policy reforms. [redacted]

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Dimensions of the Crisis

Pakistan's foreign exchange reserves declined to less than \$600 million on 1 July from a peak of almost \$2 billion in December 1983. Reserves currently are equivalent to only about five weeks' imports. [redacted]

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We estimate Pakistan suffered a record trade deficit of about \$3.6 billion for the fiscal year ending 30 June. Exports were hampered by the lingering effects of the poor cotton crop a year earlier, stiff competition from other textile exporters, and low commodity prices. Import costs increased mainly because of price increases overseas and increased imports of wheat. Domestic wheat production was below expectations for the second consecutive year. [redacted]

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Worker remittances were about 13 percent below the same period in 1984 and probably were about \$500 million below the peak in 1983. The government earlier this year estimated a net annual reduction of Pakistanis working abroad of 10,000 to 15,000, but the recent increase in the rate of return of workers from abroad suggests that the government underestimated the drop. [redacted]

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Foreign debt service probably was about \$1.2 billion last year, up from \$800 million in 1981. The debt servicing requirements include at least \$100 million in interest payments on US Foreign Military Sales as well as repayment on other military debts. [redacted]

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A severe drought cut hydroelectric power production and forced longer and more frequent power cuts than normal. Industry was particularly hard hit; US Embassy sources estimated production losses at \$3 million per day and workers had to be laid off. [redacted]

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Political Implications

The economic problems could quickly translate into political problems for President Zia. An exit poll taken during the assembly elections in February indicated that economic issues were the second most important concern of the voters, next to the implementation of an Islamic political-economic system. Severe factors have made the population more aware of economic issues:

- Hot weather and a lack of rainfall earlier this year.
- Fewer new jobs in the Middle East oil-producing countries.
- Financial constraints on government spending which have led to cutbacks in education and routine infrastructure maintenance.
- Budget pressures which have forced cuts in development programs and hampered the utilization of foreign aid.

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The government avoided contentious economic debate in the first session of the assembly by not calling for any major reforms in the new budget. It backed off from some revenue enhancement proposals and even offered more subsidies to the agricultural sector.

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A New Wish List

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Yaqub will request [] concessional credits from Washington to carry Pakistan through this year, [] [] --an amount slightly less than the debt servicing payments due the United States this year. []

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Yaqub will also review the terms of the existing aid package and ask us to quickly consider a new multi-year economic aid package that will extend the US economic and military package beyond 1987. [] Pakistan's aid requirements are projected at about \$8 billion--\$2.7 billion in economic aid and double that amount in military aid--compared to \$3.2 billion under the current program. We believe, however, this is an opening position and one that can be compromised. []

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Outlook

We estimate that, without new aid or dramatic domestic belt-tightening, Pakistan will draw down its reserves by at least \$200 million over the next year. Such a reduction would force Islamabad to make some critical and politically unappealing

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choices. For example, it might delay part of the 2 million tons of wheat it plans to import to rebuild its stocks or restrict imports of electrical generators needed to alleviate anticipated power shortages early next year. Under these circumstances, Pakistan probably would threaten to default on debt repayments.

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Domestic revenue-raising measures would also create political hazards. Zia is unlikely to risk general public unrest by supporting subsidy reduction measures that will result in higher food prices. Taxes on business and agriculture are likely to face stiff resistance because they threaten the interests of the strong bloc of conservatives and landlords. The conservative former Finance Minister, Ghulam Ishaq Khan, retains considerable influence as chairman of the new senate.

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Despite its impressive recent performance, Pakistan's economy is too weak to generate economic growth for a population of almost 100 million growing at 3 percent annually and still pay for expensive imports of military hardware. Repayments on the US FMS program alone could top \$200 million before the end of the decade, and we believe Islamabad's planned military purchases will increase the \$600 million in non-US military related debt already accumulated.

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PAKISTAN: BALANCE OF PAYMENTS ^a
Million \$

	1981	1982	1983	1984	1985 ^b
Current Account	- 991	-1,610	- 554	-1,028	-1,700
Trade Balance	-2,765	-3,450	-2,989	-3,334	-3,600
Exports (f.o.b.)	2,798	2,319	2,627	2,668	2,500
Imports (f.o.b.)	5,563	5,769	5,616	6,002	6,100
Net Services and Transfers	1,774	1,840	2,435	2,306	1,900
Worker Remittances	2,095	2,224	2,886	2,737	2,400
Long-term Capital (Net)	581	746	1,276	882	900
Gross Disbursements	956	1,092	1,301	1,234	1,300
Amortization	-516	-492	-386	-542	-550
Other	141	146	361	190	150
Other & Short-term Capital	772	629	390	-34	-40
Financial Gap	-362 ^c	235	-1112 ^c	180	840

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^aFiscal year ending 30 June of the stated year.

^bPakistani Government projections.

^cSurplus for the fiscal year.

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